SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1922.

No. 724.

ATLANTIC COAST LINE RAILROAD COMPANY, APPELLANT,

v.

A. D. WATTS, COMMISSIONER OF REVENUE OF THE STATE OF NORTH CAROLINA, AND OTHERS.

No. 727.

NORFOLK SOUTHERN RAILROAD COMPANY, APPELLANT,

v.

A. D. WATTS, COMMISSIONER OF REVENUE OF THE STATE OF NORTH CAROLINA, AND OTHERS.

No. 744.

SEABOARD AIR LINE RAILWAY COMPANY, APPELLANT,

v.

A. D. WATTS, COMMISSIONER OF REVENUE OF THE STATE OF NORTH CAROLINA, AND OTHERS.

No. 756.

THE SOUTHERN RAILWAY COMPANY, APPELLANT,

v.

A. D. WATTS, COMMISSIONER OF REVENUE OF THE STATE OF NORTH CAROLINA, AND OTHERS.

APPEALS FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE EASTERN DISTRICT OF NORTH CAROLINA.

BRIEF ON BEHALF OF THE APPELLEES.

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Attorney General of North Carolina;
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LIST OF CASES AND AUTHORITIES.

SUPREME COURT OF THE UNITED STATES.

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BRIEF ON BEHALF OF THE APPELLEES.

Statement of the Case.

These four appeals involve precisely the same matter, the power of the Legislature of North Carolina to enact the In-

come Tax Act of 1921 as applied to railroads engaged in interstate commerce. The district court upon final hearing held the statute valid, refused injunctions, and dismissed the complaints. The plaintiffs appeal to this court direct under section 238 of the Judicial Code for a review of the district court's decision as to constitutionality of the statute.

In the North Carolina Railroad Tax Cases (*Southern Railway Company v. Watts*), decided at this term, the same plaintiffs attacked the validity of this Income Tax Statute together with the validity of the *ad valorem* assessments and the franchise or privilege tax. Upon intimation of the district courts in those cases that the validity of the income tax was not properly before the court, these four plaintiffs brought these separate suits in the Eastern District of North Carolina to raise that one question. In the appeals of the former cases this court decided against the appellants several of the contentions upon which they attack the validity of the Income Tax Act in these suits. The tax here involved is the only part of North Carolina's taxing system as to railroads upon which this court has not already passed.

Constitutional Provisions.

Prior to 1921 the authority of the General Assembly of North Carolina to levy an income tax was contained in section 3 of article V of the Constitution as follows:

> "The General Assembly may also tax trades, professions, franchises, and incomes; *provided*, that no income shall be taxed when the property from which the income is derived is taxed."

A tax limited by that proviso was necessarily unproductive and its avails formed only a small part of the revenue of the State, in round numbers $500,000.00. It was, therefore, a part of the general scheme for the revision of the taxing laws of the State to remove this constitutional limitation upon income taxation. At the extra session of August, 1920, by chapter 93 of the Public Laws of that session, the General Assembly submitted to the people for their approval or disapproval at the ensuing general election in November, 1920, the following amendment which was approved and became operative on January 7, 1921:

> "1. Amend article five, section three, by repealing the proviso in said section 'that no income shall be taxed when the property from which the income is derived is taxed,' and substituting in lieu thereof the following: *Provided,* the rate of tax on incomes shall not in any case exceed six (6) per cent, and there shall be allowed the following exemptions to be deducted from the amount of annual incomes, to wit: for a married man with a wife living with him; or to a widow or widower having minor child or children, natural or adopted, not less than $2,000; to all other persons not less than $1,000, and there may be allowed other deductions (not including living expenses) so that only net incomes are taxed."

The Income Tax Statute.

Thereafter at the regular session of 1921 the General Assembly enacted as a part of the revenue laws of the State the Income Tax Act of 1921, the validity of which is here involved, Schedule D of the Revenue Act, chapter 34, Public Laws of 1921, being sections 100 to 904, inclusive, of that

act. It is set forth in full in the complaints and in the briefs of the appellants.

This statute taxed income earned during the calendar year of 1921, the tax being due and payable March 15, 1922. The net proceeds of the tax for 1921, excluding the amounts assessed on the appellants, the four largest railroads in the State, were $2,408,000.00 in round numbers. The amounts assessed on these four railroads were: Southern, $71,522.06; Seaboard, $13,133.09; Atlantic Coast Line, $41,686.96, and Norfolk Southern, $19,616.46; a total for the four of $145,-959.54. This has not been and will not be paid pending the decision on these appeals.

The rate of the income tax is the same for all corporations—3 per cent of the net annual income from business within the State. From the necessity of the case, the statutory method of ascertaining what is the taxable net income differs in the case of individuals, ordinary corporations, and public-service corporations. In particular, this method necessarily differs in the cases of public-service corporations doing a business wholly within North Carolina, the total net income from which is taxed, and like corporations doing interstate business partly within and partly without the State, and only North Carolina's proportion of the net income from which is taxed.

The complication necessary as incident to the determination of this proportionate net income taxable by North Carolina in the case of interstate carriers is the reason for the principal classifications as to method of ascertainment of net income made by the statute.

As to all classes, it levies a tax on "net income," and it defines net income, in section 300, as being "the gross income

of a taxpayer, less the deductions allowed in this act." In section 301 the words "gross income" are defined by a statement of the items of revenue included within that term as taxable, and the items which are exempt from taxation and not to be comprehended within the term "gross income."

The principal classification is the division of taxpayers for purposes of ascertaining the taxable net income, into three classes: *first,* individuals; *second,* railroads and other public-service corporations "required to keep records according to the standard classification of accounting of the Interstate Commerce Commission;" *third,* other corporations.

As to the *first* class—individuals—the peculiarity is that they are allowed no deduction from gross income of personal, living, or family expenses (section 307). Consequently, individuals are required by the State to pay tax on their net incomes as defined by the act, although every cent of such income was expended for those absolutely necessary personal or family expenses without which the taxpayer or his family could not continue to exist. There is no corresponding provision as to corporations of any class, so that all corporations are allowed deductions for those necessary expenses without which the corporation could not continue its corporate life and business.

As to the *second* class, since the members thereof are required, either by the Interstate Commerce Commission or by State authority, to keep, and do keep, their records and accounts according to the very complete and excellent standard classification of accounting of the Interstate Commerce Commission, which standard classification exhaustively provides for the tabulation of operating revenues, operating expenses, and the ascertainment of net operating income, the respective

items are required to be returned for income tax according to, and the net income taxable to be ascertained with reference to, that classification of accounts. Section 202 contains the statutory method of ascertaining "net income" from the said standard classification of accounting.

It is against the classification contained in section 202 of the act that the appellants direct their contentions that the statute is discriminatory against interstate carriers and violates the 14th Amendment and the uniformity clause of the State Constitution.

Their argument in brief is: the Interstate Commerce Commission requires only railroads engaged in interstate commerce to keep the standard classification of accounts; section 202 provides a method of determining taxable net income for all railroad or other public-service corporations who are "required to keep records according to the standard classification of accounting of the Interstate Commerce Commission" different from the method of determining taxable income of railroads and other public-service corporations not required to keep such accounts; therefore it discriminates between corporations within the class of railroads and against those members of the class engaged in interstate commerce.

This we shall show is not the fact. All other railroads and public-service corporations of whatever kind are "required" by State authority to keep accounts according to the standard classification of accounting of the Interstate Commerce Commission and to return for income tax under the provisions of section 202 exactly as are the plaintiffs. Not only all railroads, domestic and foreign, interstate, connecting with interstate, and wholly intrastate, are taxed exactly alike and their taxable net incomes ascertained in the same way under the

method of section 202, but the same is true of all public-service corporations.

Contentions of the Railroads.

The contentions of the appellants upon which they lay the greatest stress are two:

First, that the tax is not a tax on net income, but is levied on gross income or on "net operating income," and hence is repugnant to the State Constitution and to the commerce clause of the Federal Constitution.

Second, that the classification made by section 202 of the act as to method of ascertainment of net income for the plaintiffs and other corporations within the designated class is arbitrary, without reasonable or practical basis, and hence is repugnant to the uniformity clause of the State Constitution and to the equal-protection clause of the Fourteenth Amendment.

Other minor complaints made against the tax are:

Third, that it is a violation of the State Constitution for the general property tax to be devoted to local purposes and the various excise, privilege, franchise, and license taxes and the income taxes to be devoted strictly to State purposes.

Fourth, that the income tax is invalid because it is levied in addition to property and franchise or privilege taxes.

Fifth, that the method of ascertaining their taxable income fixed by section 202 violates the uniformity clause of the State Constitution, or the Fourteenth Amendment, because it does not apply to those railroads or other public-service

corporations which do not operate their properties, but have income only from rentals paid them by other companies to which they lease their entire properties to be operated by the lessees.

Sixth, the Seaboard and the Atlantic Coast Line make the contention, not made by the other plaintiffs, that section 202 requires the plaintiffs to keep an accounting system in repugnance to power delegated by acts of Congress to the Interstate Commerce Commission.

Seventh, it is contended that the Income Tax Act is retroactive as to the months of January and February and as to eight days in March, 1921, because taxing the income for the whole year, and only ratified on the 8th of March, 1921.

Those seven contentions include all the points made by the appellants in their complaints in these suits. Two of them, the third and the fourth, have already been decided against them in the decision of the North Carolina Railroad Tax cases at this term. The remaining five we shall consider in this brief. Since these cases have been advanced together for argument, and since a motion for consolidation is pending, and the questions involved in the four suits are identical, we file but one brief of the appellees for the four appeals.

These appeals differ from those heard and decided by this court at this term and reported as Southern Railway Company *v.* Watts, in that the present appeals involve no attacks upon the administration of statutes, but raise only the constitutional question as to the validity of the Income Tax Act itself.

ARGUMENT.

I.

This is a tax on net income and not on gross income, and is therefore within the constitutional power of the State and repugnant neither to the State Constitution nor to the commerce clause of the Federal Constitution.

1. *A Tax on Net Income of an Interstate Carrier is Valid.*

The first contention of the appellants is that under the income-tax clause of the State Constitution and under the commerce clause of the Federal Constitution the State is limited to taxing net incomes, and that the tax here in question is not in truth a tax on net income but on gross income or on net operating revenue (which they contend includes some gross income), and hence repugnant to both constitutional provisions.

The basis for this contention is the same as that for the contention that the statute makes an arbitrary classification, is discriminatory, and violates the Uniformity Clause of the State Constitution and the 14th Amendment of the Federal Constitution—the fact that under the provisions of section 202 the taxable net income of corporations to which that section applies is ascertained without allowing deduction of interest on bonded indebtedness and of rentals paid on long-term leases, whereas other taxpayers in general are allowed deduction of interest paid and of business rentals.

We shall consider these distinctions in the method of ascertaining taxable net income more in detail when we come

to the discussion of the contention as to discrimination. For the present we shall consider them only in so far as they bear upon the question whether this tax on railroads is a tax on net income in a constitutional sense.

It is so well settled as to be no longer the subject of discussion that it is within the constitutional power of a State to levy an income tax on the net incomes earned within the State of persons and corporations engaged in interstate commerce, and that such a tax is not a burden on interstate commerce and does not violate the commerce clause, although the net incomes taxed may be derived in part or mainly from the business of interstate commerce.

U. S. Glue Co. v. Oak Creek, 247 U. S., 321;
Shaffer v. Carter, 252 U. S., 37, 57;
Travis v. Yale and Towne Mfg. Co., 252 U. S., 60, 75;
Underwood Typewriter Co. v. Chamberlain, 254 U. S., 113.

The constitutional distinction between such a tax and a tax on the whole volume of business or on the gross income or revenue of one engaged in interstate commerce, which is held to be a burden on interstate commerce and a violation of the commerce clause, is clear.

Compare *Crew Levick Co. v. Pennsylvania*, 245 U. S., 292, and cases there cited.

An exact analogy is to be observed in the restriction imposed upon Congress by article I, section 9, clause 5, of the Constitution, "No tax or duty shall be laid on articles exported from any State." Under that clause it is held upon exactly the same reasoning that a tax by Congress measured

by gross revenues from the business of exportation is a direct burden on such business, and hence is a tax on exports and invalid, but that a tax on net incomes from such business is no more than an indirect burden thereon and is therefore not a tax on exports and is valid.

Peck & Co. v. Lowe, Collector, 247 U. S., 165.

Even if the Constitution of North Carolina in the income-tax clause limits the Legislature to a tax no more onerous than a tax on net income, still that limitation would be exactly coextensive with the limitation of the commerce clause of the Federal Constitution. If, therefore, the tax here in question is a tax on net income within the meaning of the limitation imposed by the commerce clause, it cannot be successfully attacked as not being a tax on net income under the State Constitution.

2. *What is "Net Income?" Legislative Power of Definition.*

The pertinent provision of the State Constitution is:

> "The General Assembly *may also tax* * * * *incomes: Provided,* the rate of tax on incomes shall not in any case exceed six per cent (6%), and there shall be allowed the following exemptions, to be deducted from the amount of annual exemptions, to wit: for a married man with wife living with him, or to a widow or widower having minor child or children, natural, or adopted, not less than $2,000; to all other persons not less than $1,000, *and there may be allowed other deductions (not including living expenses), so that only net incomes are taxed."*

This is couched in the language of a non-self-executing, as contrasted with a self-executing, constitutional provision. The language is purely permissive. The General Assembly may, or may not, as it sees fit, impose the tax. It is in direct contrast with the requirement as to property tax, which is mandatory: "Laws *shall be passed* taxing by a uniform rule all moneys," etc. The permissive provision as to income taxation is not self-executing.

The distinction between the two kinds of constitutional provision is pointed out by the Supreme Court of North Carolina in the case of *Kitchen v. Wood,* 154 N. C., 565, wherein it is said:

> "We have reached the conclusion that section 1, article V of the Constitution of this State, is mandatory, self-executing and leaves nothing to the discretion of the lawmaking power.
>
> "Its plain mandate is that the General Assembly 'shall levy a capitation tax on every male inhabitant of the State, which shall be equal to the tax on property valued at $300 in cash.'
>
> "As said by the Attorney General, 'In the execution of this command, the General Assembly acts in a purely ministerial capacity. Its function is executive and not legislative. It is made the agent, the accountant, of the Constitution, with directions to make a calculation and record it.' * * *
>
> "As to whether a particular constitutional provision is self-executing seems to be one of intention to be gathered from the instrument itself and determined by the language used and the purpose intended to be carried out.
>
> "The provision in our organic law is complete in itself, needs no legislation to give it effect, and no

> special means for its enforcement. Provisions of that character are regarded as self-executing. *Groves v. Slaughter*, 15 Peters (U. S.), 449; *Davis v. Burke*, 179 U. S., 399; *Newport News v. Woodard*, 7 Am. and Eng. Anno. Cases, 627, and cases cited in notes."

Under this rule, of course, the income-tax provision of the State Constitution is not mandatory, is not complete in itself, does leave something to legislative discretion, and does need legislation to give it effect. The act of the Legislature in passing an income-tax statute pursuant to this permissive provision is, therefore, a sovereign legislative act, not an executive or ministerial one. It is clearly within the competency of the Legislature to define "income" or "net income," to prescribe what deductions shall be allowed from gross income, so that net income only shall be taxed. This discretion is expressly left to it. And it is within the discretion of the Legislature to fix the rate of the tax.

The State Constitution merely uses the term "net income." It does not define it. Is it a term which needs definition, which is susceptible of definition? If so, what power shall make that definition if it be not the Legislature?

The term "net income" is not so definite in its signification as, by its own force, to set apart that portion of one's earnings which shall constitute, without further legislation, "net income."

Here are the definitions of "net income" to be found in the books:

Bouvier's Law Dictionary:

> "The excess of the gross earnings over the expenditures defrayed in producing them, aside from, and exclusive of, the expenditure of capital laid out in

constructing and equipping the works themselves. *Union Pacific R. Co. v. United States*, 99 U. S., 420. See *Barry v. Railroad Co.*, 27 Fed., 1; *St. John v. Railroad Co.*, 22 Wall. (U. S.), 148; *Sioux City R. R. Co. v. United States*, 110 U. S., 205."

29 Cyc., 671:

> "Of a business or corporation, the products of a business, deducting the expenses only."

In the case of *American Loan & Trust Co. v. East, etc., R. Co.*, 36 Fed., 101, 102, "net income" was construed as meaning "all over and above operating expenses."

In the case of *Kansas City So. Ry. v. United States*, 231 U. S., at 445, the Supreme Court gave the very same definition of "net earnings" as that given by Bouvier for "net income," wherein it was said, quoting from *Union Pacific R. Co. v. United States*, 99 U. S., 402:

> "As a general proposition, net earnings are the excess of the gross earnings over the expenditures defrayed in producing them aside from, and exclusive of, the expenditure of capital laid out in constructing and equipping the works themselves. It may often be difficult to draw a precise line between expenditures for construction and the ordinary expenses incident to operating and maintaining the road and works of a railroad company."

That quotation from this court's decision points out the very indefiniteness of meaning of the expression net income or net earnings, the very necessity for definition of such expression which has given rise to these suits. It is impossible to draw an accurate, theoretical, and precisely technical line

of demarcation between what are capital expenditures, laid out in constructing and equipping the works themselves, on the one hand, and the mere ordinary expenses incident to operating and maintaining the road and works of a railroad on the other.

The appellants contend that the interest which they pay on their bonded indebtedness and the rentals which they pay on 99-year leases of subsidiary railroads are current business expenses, the mere ordinary expenses incident to operating and maintaining their roads and works. The appellees contend that they are capital expenditures, laid out in constructing and equipping the works themselves; that railroads are largely financed by their bonds, that their long term leases of subsidiary roads amount practically to purchases, entirely distinguishable from current rentals paid by an ordinary business corporation for its place of business (see affidavit of A. J. Maxwell, A. C. L. Record, pp. 57-59), and that net income is arrived at without allowing these deductions.

Both contentions may savor of the technical, the hypercritical. They show, however, that very difficulty which this court pointed out in the *Kansas City So. Ry. Case, supra,* of drawing the precise line.

The appellants here ask the court to adopt their technical definition of "net income" and to strike down the revenue statute of North Carolina because its definition does not correspond to theirs. That is exactly the sort of thing which the court refused to do in the case just cited.

In that case it was held that, by reason of this difficulty in arriving at an exact judicial definition of "net earnings," it was competent for the Interstate Commerce Commission,

under the general authority given it by Congress to require systems of accounts, to provide what particular items should be included in expenses, and deductions allowed, in order to arrive at net earnings.

The same sort of contention was made in this court as to the corporation tax of 1909, 36 Stat., 112, in the case of *Anderson v. Forty-two Broadway Company*, 239 U. S., 69.

The statute imposed a special excise tax equivalent to one per centum upon the entire net income over and above five thousand dollars. It defined "net income" by authorizing deductions from gross income, among other things, of "interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded or other indebtedness not exceeding the paid-up capital stock of such corporation." A realty company in New York had only $600 of capital stock and a bonded indebtedness of $4,750,000 secured by mortgages on real estate.

The taxpayer contended and the district court and the circuit court of appeals held that it should be allowed to deduct interest paid on this bonded indebtedness in arriving at "net income," in view of another provision of the statute which permitted deduction of "all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property," and in view of its contention that if this deduction be not allowed its tax would not in truth be measured by a percentage of its net income.

This court dismissed that contention with these words:

"With these views we cannot agree. There was error, as it seems to us, in seeking a theoretically accurate definition of 'net income,' instead of adopting the meaning which is so clearly defined in the act itself."

And the same contention was again made here by a taxpayer attacking the Federal Income Tax law of 1913 in its application to mining corporations in the case of *Stanton v. Baltic Mining Company,* 240 U. S., 103.

The mining company there contended that by reason of the differences in the allowances which the statute permitted the tax levied was virtually a net income tax on other corporations and individuals and a gross-income tax on mining corporations (p. 111), and the court said, as to that and many other similar contentions:

"But it its apparent from the mere statement of these contentions that each and all of them were adversely disposed of by the decision in the *Brushaber case* (240 U. S., 1), and they all therefore may be put out of view."

In the same way it has been held by the Supreme Court of North Carolina that since the Constitution did not define "petty misdemeanors," and since there was no well-defined line of demarcation when that instrument was adopted, it is competent for the General Assembly to define and mark out the offenses which shall be so classified.

State v. Lytle, 138 N. C., 738;

See, also, *State v. Collins,* 151 N. C., 648.

Again, section 6 of article VI of the State Constitution is as follows: "All elections by the people shall be by ballot,

and all elections by the General Assembly shall be *viva voce.*" It was held, under this section, that while "ballot" means a written or printed expression of the will of the voter, the Legislature has the discretion to prescribe the size, form, and character of the ballots to be used, and that the constitutional provision does not prevent it from regulating the conduct of the elector and the officers at the polls.

Deloatch v. Rogers, 87 N. C., 358;
Baxter v. Ellis, 111 N. C., 124;
Slaymaker v. Phillips, 5 Wyo., 453; 47 L. R. A., 842.

In the case of *Jenkins v. Board of Elections,* 180 N. C., 169, the court held that the terms "offer to vote" in article VI of the Constitution do not have such a well-defined meaning as to prevent the Legislature from defining them as not requiring the personal presence of the voter at the polls at the time he votes. See, also, *State v. Nevada Central R. Co.,* 113 A. S. R., 834, and *New York v. Manhattan R. Co.,* 192 N. Y. S., 90.

In *State v. Webb,* 155 N. C., 426, it was held that the word "speedy" in the provision of the Constitution requiring speedy trials of persons charged with crime is of indeterminate meaning, permitting legislative definition.

It seems, therefore, perfectly clear that the expression "net income," as used in the State Constitution and as used in the decisions of this court under the commerce clause, is not an expression of exact technical meaning; that judicial definitions of it are always in general terms, and that it is within the competency of the Legislature of the State to define its meaning.

3. *The Definition of "Net Income" in This Statute. What North Carolina Taxes as to the Plaintiffs.*

Let us see what North Carolina seeks to tax as to each of the plaintiffs. The facts are the same as to all and they may be considered together. They are all interstate carriers engaged in business partly within and partly without this State. The net income for taxation of each is ascertained in the same way under section 202, the pertinent and essential parts of which read as follows:

> "The basis of ascertaining the net income of (the plaintiffs) * * * shall be * * * their net income within this State shall be ascertained by taking their gross 'operating revenues' within the State, including * * * the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' (so ascertained) the proportionate average of 'operating expenses,' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounts."

Following the mathematical operation thus far outlined by the statute leads to a result which the statute calls the "net operating income" of the taxpayer. *It is not this which is taxed, however,* although all of the operating expenses allowed by the Interstate Commerce Commission to be included in that term have already been deducted from gross revenues. The statute proceeds to authorize other specific deductions from this so-called "net operating income" in order to produce the resulting taxable *net income.* It continues:

"From the net operating income thus ascertained shall be deducted 'uncollectible revenue' (in other words, losses or bad debts) and taxes paid in this State for the income year, other than income taxes and war profits and excess-profits taxes, and the balances shall be determined to be their net income taxable under this act."

In addition, chapter 35, Public Laws of 1921, amended section 202 so as to decrease or to charge to increase net income as so found, any debit paid or any credit received by the railroad for car hire. The full text of this amendment is printed in the margin.[1]

To understand, then, what has actually been allowed to the plaintiffs as deductions from their gross revenues earned in North Carolina, we must look to the standard classification of accounts of the Interstate Commerce Commission to see what that classification includes in the term "operating expenses" or "operating ratio," all of the items of which are allowed to the plaintiffs as deductions.

The plaintiffs have filed affidavits in these suits, attaching as exhibits the regulations of the Commerce Commission as to standard classification of accounts, and we pray the court to make reference to these exhibits to see the extreme com-

[1] "SEC. 1. That in determining the taxable income of a corporation engaged in the business of operating a railroad under section two hundred and two of the act to raise revenue, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire."

pleteness of detail with which every conceivable expense is included. (See affidavit of J. C. Nelms, Jr., and attached exhibits, Atlantic Coast Line Record, pp. 67-82.)

Many expenses are included which are not allowed as deductions under the Income Tax Law of North Carolina to any other taxpayers or class of taxpayers than those required to keep this standard classification of accounts, a few of the more important of which are: purchase of tools and small equipment, which are allowed as expenses to railroads under this classification, but which are considered as capital invested in the case of other taxpayers; the extremely important item of money paid out by the railroad upon judgments, but which is not allowed other taxpayers than public-service corporations keeping the standard classification of accounts; and all amounts paid out as premiums for insurance of all kinds—fire, storm, liability, and casualty. A general summary of these items included in the standard classification of "operating expenses" or "operating ratio" has been attached to the answers in these suits, and space forbids even such general summary here. (See A. C. L. Record, pp. 30-31.) Reference is made to the standard classification itself in the regulations of the Commission.

It needs only a glance at section 202 of the act and at the standard classification of accounts to find the refutation of the contention of the railroads that while other taxpayers are taxed on their net incomes the railroads are taxed on "net operating revenue" or "net operating income."

The first item of the calculation in arriving at the taxable net income of the appellant railroads is "gross operating revenue" within the State according to the standard classification, including the mileage proportion attributable to

North Carolina of interstate business. This item is not taxed, but from it are deducted all those multitudinous items included in the standard classification as "operating expenses" or "operating ratio." The result of this subtraction is the second item of the calculation called by the statute "net operating income." It is not taxed, as appellants seem to contend, but from it are in turn deducted uncollectible revenues and taxes. The final result is, in express terms and in fact, NET INCOME, and it is that net income which is taxed.

4. *This is a Tax on Net Income and Therefore Valid.*

We have seen what the statute taxes with reference to all taxpayers included within the scope of section 202; the legislative definition of what taxable "net income" shall be as to those taxpayers.

We submit that this definition contained in the statute is strictly in conformity with the definitions of "net income" or "net earnings" in judicial opinions and particularly in the opinions in the cases of *Union Pacific R. Co. v. United States,* 99 U. S., 402, and of *Kansas City So. R. Co. v. United States,* 231 U. S., at 455.

This statutory definition allows to the plaintiffs deductions of all operating expenses, all expenses incurred in the business of earning the gross revenues and adjusts their losses. The tax is imposed, not on gross revenues, still in the business, before the deduction of expenses and the adjustment of losses, but is imposed purely on the net income apportionable to North Carolina, after that income has been separated from the general business operations of the plaintiffs by deduction of the expenses of producing the revenue and of the

losses incurred in its production. The imposition is, therefore, not a direct burden on interstate commerce, but is, at most, only an indirect burden, not prohibited by the commerce clause, but strictly within the distinction made in the cases of *Crew Levick Co. v. Pennsylvania*, 245 U. S., 292, on the one hand, and of *Peck & Co. v. Lowe*, 247 U. S., 165; *U. S. Glue Co. v. Oak Creek*, 247 U. S., 321; *Underwood Typewriter Co. v. Chamberlain*, 254 U. S., 113, and others, on the other.

Why do the appellants contend that it is not in fact and in law a tax on net income?

The first reason they give is that the Interstate Commerce Commission has given a different definition of "net income" for its rate-making purposes. In the district court it was squarely argued by the railroads, and we assume will be argued here, that the Legislature of North Carolina had not the power to make the definition of "net income" made by section 202 of the statute, because the Interstate Commerce Commission has made a different definition for rate-making purposes.

We know of no principle or authority to the effect that such a definition by the Federal administrative commission, in pursuance of its rate-fixing function, should have any binding or controlling force to preclude the Legislature of a State from making a different definition, in pursuance of its sovereign taxing power, and the appellants have cited us to none.

The only authority we have seen cited to this proposition is the case of *Stratton's Independence v. Howbert*, 231 U. S., 399, which is asserted to contain a definition of "net income" at variance with that made by the Legislature of North

Carolina. The opinion in that case contains nothing whatever in the way of a definition of net income. It does define income as being "the gain derived from capital, from labor, or from both combined." And this, we take it, is the well-recognized definition of income. It contains nothing which helps the contention of the appellants.

The appellants point out that under the standard classification of accounting of the Interstate Commerce Commission there are two classes of accounts as to revenues and expenses: (1) Operating revenues and operating expenses accounts; and, (2) income, profit and loss, and general balance-sheet accounts.

The accounts of the first class include only revenues proceeding from and expenses incident to the actual business for which a railroad is created, transportation in commerce. The accounts of the second class include other sources of revenue not included in those of the first class and include all expenditures, whether capital expenditures or current business expenditures, and the result of those accounts is to strike a balance of all revenues and all expenses and arrive at a "net balance of income (or loss)" which shall be carried to "profit and loss." (See brief of Norfolk Southern, pages 13 to 16.)

They contend that it is this "net balance of income," this profit, which the State should tax as their net income, and that this statute is unconstitutional because it disregards all income except that derived from the main business for which the taxpayer is organized and fails to allow as deductions corresponding expenses which are not current business expenses incident to that main business.

There have been some theorists who have argued that the

wisest and fairest, if not the most productive, tax would be a tax which allows the taxpayer at the end of the year to strike an absolute balance of all income and of all outgo and to be taxed solely on the net profit or savings which he could put away after all of his expenditures had been settled. That sort of tax would tax railroads on the "net balance of income" carried to "profit and loss" as shown in the "income, profit and loss, and general balance sheet accounts" of the standard classification. That sort of tax would tax an individual only on that net profit or saving which he is able to put in the savings bank at the end of the year after the payment of all of his personal and family living expenses and all debts due and payable.

But, so far as we are informed, such a tax has never yet been adopted by any State or nation. It is certain that the fact that an income tax is not such a tax does not render it unconstitutional and does not mean that it is not a tax on net income. If that did follow, neither the Federal income tax nor any State income tax would be a tax on net income.

Passing, then, from their argument that the Interstate Commerce Commission has taken this power of definition away from the Legislature of North Carolina, the appellants squarely contend that this tax is a direct burden on interstate commerce as being a tax on gross income instead of on net income, because it does not allow to those taxed under section 202 deduction of interest paid on funded and unfunded debt, interest paid on bonds.

This court has often said that it cannot close its eyes to well-known facts, and that it will take judicial notice of matters of common knowledge and of current and public

history. We think it will take judicial notice of the fact that the greatest part of the capital assets of railroads is raised by bond issues. The defendants below introduced evidence to this effect at the final hearing. (See affidavit of A. J. Maxwell, Atlantic Coast Line Record, pp. 57 to 59.)

Although railroads do have common and preferred stock it is usually of low market value and frequently earns no dividends. Railroads are built and financed by bond issues. As to them, therefore, their bond issues are analogous to the stock of ordinary corporations, particularly the preferred stock. No corporations are allowed deductions of dividends paid on preferred stock, as interest, under the North Carolina Income Tax Act (section 306, subsection 3).

It was precisely the same line of reasoning as that contained in the affidavit of Mr. Maxwell which caused the Congress to place the limit on the Corporation Tax Act of 1909 as to the extent to which interest on bonded indebtedness could be allowed as a deduction. When, in the case of *Anderson v. Forty-two Broadway Company*, 239 U. S., 69, which we referred to above, the taxpayer made the same argument these railroads are now making, that interest on bonded indebtedness must be allowed as a deduction, otherwise the tax would not in fact be a tax on net income, this court answered that contention by the same reasoning as that in Mr. Maxwell's affidavit. It said:

> "It is not necessary to attribute to Congress a purpose to discourage or impose an extra burden upon corporations carrying on their operations with a nominal capital stock, or with an indebtedness largely exceeding the amount of the capital. It is more reasonable to say that Congress deemed that where the

indebtedness does exceed the capital it should no longer be treated as an incident, but that the carrying of the indebtedness should be considered as a principal object of the corporate activities, that the operations of such a corporation are conducted more for the benefit of the creditors (bondholders) than of the stockholders, and that the contribution of the corporation to the expenses of the Government should be admeasured with this fact in view. There is no question of the power of Congress to adopt such a basis of distinction, and, since the line must be drawn somewhere, it was certainly not arbitrary to draw it at the precise point where the pecuniary interest of creditors overbalanced that of stockholders."

In other words, under the definitions of net income above quoted, it is gross income, less only the expenses and losses incurred in earning that income, not less any expenditure for capital, capital assets, or permanent equipment. Interest on bonded indebtedness is a *capital expense,* and incident to the creation of the capital and capital assets of the corporation. It is not an operating expense incident to the business of earning the revenue. There is no logical reason why it should be allowed as a deduction.

The plaintiffs complain that individuals and other corporations are allowed to deduct interest on indebtedness, and that they are not. They do not see that the difference is that the interest they wish to deduct is interest on capital indebtedness, while that which individuals and other corporations are allowed to deduct is interest on current business indebtedness expended in the operations of the business. Other corporations are allowed no deduction for the dividends on preferred stock which correspond to the railroad's interest on bonds.

Again, the appellants complain that other business corporations are allowed to deduct rentals and that they are not allowed deductions for rentals paid by them for the lease of other railroad lines operated by them. We answer this contention in the words of Mr. Maxwell in his affidavit (Atlantic Coast Line, Record, p. 58):

> "With reference to the matters of rentals paid for the lines leased and operated by the railroads, the committee considered the well-known facts that these leases are usually for long terms and with numerous collateral obligations which make them amount practically to purchases of the lessor road's properties by the lessee, and that, this being true, the consideration paid for such long leases of property used fully as if the property of the lessee in its business is really not an operating expense but is by clear analogy and in practical effect a capital expense. If these expenses were allowed as deductions to the plaintiffs, the result would be that they would have no income subject to tax until they had earned enough to provide, not only for all business and operating expenses, but also for all capital expenses and had paid all interest on their bonds; in other words, it would amount to nothing more than a tax on the savings of railroads, which would render the tax utterly incommensurate with that imposed as income tax on individuals and other ordinary corporations."

The distinction between the rentals paid on these long 99-year leases and rentals paid by an ordinary business corporation for offices and a place in which to do business is manifest. It is again the logical distinction between capital expenses and operating or business expenses. The lessee railroad is, under the covenants contained in these leases, prac-

tically the owner of the leased line for the period during which the lease is to run. The rentals paid by it are capital expenses or capital investment, and not operating expenses. In this the Interstate Commerce Commission agrees with the contentions of this brief, for such rentals are not included as operating expenses in its standard classification of accounts.

Remembering that this question as to whether the income tax here considered is a tax on net income or on gross income is a question of power and not of propriety, we reply to all arguments of the appellants as to the propriety or wisdom of allowing deduction of these items of interest and rentals by the following language of this court from the opinion in the case of *Brushaber v. Union Pacific R.*, 240 U. S., 1, 25:

> "In this situation it is of course superfluous to say that arguments as to the expediency of levying such taxes or of the economic mistake involved in their imposition are beyond judicial cognizance."

We think we have demonstrated the propriety of the Legislature's definition of net income as to taxpayers taxed under the provisions of section 202 of the statute. We are confident, however, that there can be no doubt as to its power to make that definition.

We conclude that the Income Tax Act of 1921 imposes on the plaintiffs a tax on net income within the ordinary meaning of the term and within the definition of such tax given by all the authorities binding upon this court; that such tax is in no way inhibited, but, on the contrary, is specifically authorized by the Constitution of North Carolina; that under the well-defined rule of the Supreme Court of the United States this tax is not a direct burden on interstate commerce,

although the net income taxed may proceed largely from interstate commerce, and in no way violates the commerce clause; that it is repugnant, therefore, neither to the Constitution of the State nor to the Constitution of the United States.

II.

The classification of which the appellants complain is upon a practicable and reasonable basis and is no such arbitrary discrimination as is prohibited by either the uniformity clause of the State Constitution or the Fourteenth Amendment.

1. *The Contentions of the Appellants as to Classification.*

It would be useless for us to review the decisions of this court in which it has passed upon the validity of taxing and other statutes of States, attacked upon allegations of discrimination and repugnancy of classification to State uniformity provisions and to the Fourteenth Amendment.

We shall concern ourselves with the statute and the matters in the records in these suits and with an attempt to demonstrate that the classification of the statute in question is perfectly competent under the well-settled principles enunciated by this court in the cases of *Bell's Gap R. Co. v. Pennsylvania,* 134 U. S., 237; *Magoun v. Illinois Trust & Savings Bank,* 170 U. S., 283, and the many subsequent cases, as recent as *Dane v. Jackson,* 256 U. S., 589, *Heisler v. Thomas Colliery Co.,* No. 541 this term, decided November 27, 1922, and *Southern Railway Company v. Watts,* No. 368 this term, decided January 2, 1923.

The contention of the appellants is that for the statute to make a class of *"every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission,"* and to provide that the taxable net income of members of that class shall be ascertained by a rule of calculation different from that provided with respect to taxpayers not of that class, is arbitrary classification, discrimination, and violates the uniformity provision of the State Constitution and the Fourteenth Amendment.

It would seem that the mere statement of this proposition is its own sufficient answer.

Even had that classification effected by the statute been much narrower that it is and had it included only railroad corporations, it is so well settled as to be no longer the subject of discussion that the classification of railroad corporations together is valid classification, that it is perfectly competent for a State, both under its own uniformity rule and under the Fourteenth Amendment, to provide a different method of taxing railroads from that provided for taxing other corporations and other individuals.

State Railroad Tax Cases, 92 U. S., 575;
Kentucky Railroad Tax Cases, 115 U. S., 321, 337;
Missouri v. Lewis, 101 U. S., 22;
Missouri Pacific R. Co. v. Mackey, 127 U. S., 205;
Minneapolis, etc., R. Co. v. Beckwith, 129 U. S., 26;
Bell's Gap R. Co. v. Pennsylvania, 134 U. S., 232;
Pacific Express Co. v. Seibert, 142 U. S., 339.

For the double reasons that it is not a fact and that if it were it would constitute no unconstitutionality in the statute, therefore, we do not expect the appellants to press here the contention argued by them in the district court, that the statute in question is invalid as putting railroad corporations in one class and taxing them by a different rule from all other taxpayers.

The appellants go a step farther, however, and contend that the statute makes an arbitrary classification even within the general class of railroad corporations, in that it bases the classification as to those who are taxed under the provisions of section 202 on the question whether they are "required to keep records according to the standard classification of accounting of the Interstate Commerce Commission." And they assert that this is not a reasonable basis of classification. They argue that only railroads engaged in interstate commerce are "required" (by the Interstate Commerce Commission) to keep the standard classification of accounting and that the statute therefore in effect enacts a hostile discrimination against corporations engaged in interstate commerce.

These contentions make it necessary to examine with care the question of what taxpayers are actually included within the provisions of section 202.

2. *The Classification Actually Made by the Statute and Laws of North Carolina.*

Section 202 of the statute does not limit the scope of its provisions to corporations of the classes designated which are "required by the Interstate Commerce Commission" to keep the standard classification of accounts. It merely creates

a class of those "required" to keep their accounts according to that classification of accounts.

They may be "required" by either Federal or State law, by rule of the Interstate Commerce Commission, or of the revenue department of the State.

The fact is, as shown by the records in these appeals, that not only railroads engaged in interstate commerce, but all railroads doing business as common carriers in North Carolina, all electric railroads, express companies, telephone or telegraph companies, and all public-service corporations of whatever kind, are taxed exactly alike under the Income Tax Act of 1921 and are required to make return of their taxable net income under the provisions of section 202 of this act and to calculate their taxable net income in the same way and with only the same deductions as the appellants in this cause. There is no basis in fact for the contention that there is a discrimination against carriers engaged in interstate commerce.

The records show (Atlantic Coast Line, Record, pp. 54 to 56) that the State department of revenue has only one blank for returns of income tax which is sent out to and used by all railroads engaged in the operation of railroads. This is form 7, a copy of which was attached to the affidavit of O. S. Thompson (Record cit., 54), but was by mistake not printed in the record in connection with that affidavit. A copy of that form is attached to this brief as Appendix A. As shown by that affidavit, this form is required by the State department of revenue to be filled out by all railroads doing business in North Carolina, whether operating wholly within the State or both within and without, whether operating wholly within the State, but as connecting carriers with in-

terstate railroads, or whether doing a purely intrastate business.

This form and the rules of the department of revenue require report by all such railroad corporations of their net income as defined by and calculated according to the provisions of section 202 of the statute and based upon and according to the standard classification of accounts of the Interstate Commerce Commission.

And the affidavit says further:

> "Affiant states, therefore, as a matter of his own knowledge, that the Income Tax Act of 1921, as administered by the State department of revenue, applies exactly in the same way and without any discrimination whatsoever to all railroad corporations doing any business in the State engaged in railroad operation, whether foreign or domestic, whether operating partly within and partly without the State, or wholly within the State. All are required to make return for income tax according to the standard classification of accounts and under section 202, *and exactly the same deductions are allowed to all, without discrimination.*"

The records further show (Atlantic Coast Line Record, p. 56, where a line is omitted in the printing, *compare* Southern Record, p. 31, bottom, which is printed correctly) that not only is the entire class of railroads engaged in the railroad business subjected to income taxation under the provisions of section 202, but that the same is true as to the far broader class of all strictly public-service corporations.

The State department of revenue has only one form for income tax return for all public-service corporations other

than railroads, form 8, a copy of which was attached to the affidavit of Thompson (Record cit.) but by error has been omitted from the printed records and which is attached to this brief as Appendix B. So that the department of revenue requires not only of all railroads engaged in railroading, but of all public-service corporations, that they file returns for income tax upon the basis of the standard classification of accounts under the provisions of section 202. As to all of those corporations taxable net income is ascertained in exactly the same way and the same deductions only are allowed.

The plaintiffs below, however, found two lumber companies which have constructed short lumber railroads for the prosecution of their lumber business and transportation of their lumber products to connecting common carriers and secured from them affidavits to the effect that they were not taxed under the provisions of section 202, but were allowed and entitled to be allowed under the law the deductions allowed to private corporations not engaged in public service (Atlantic Coast Line Record, pp. 25 to 28).

They then argued that here were two "railroads" which were not included in the statutory classification of railroads, and which were taxed not as railroads and public-service corporations, but as ordinary private business corporations. This is the basis of their contention that they are discriminated against because they are engaged in interstate commerce.

We think that such a contention would not merit attention here except for the fact that it is the final resting place upon which the appellants must place their contention of invalidity of the statute.

Of course these lumber companies are not railroads. Their little lumber roads are operated as a pure incident to their main business of manufacturing and selling lumber. They are not even allowed to transport commodities of others except to a limited degree, and they are classed by the State Corporation Commission (the public utilities commission) as "limited common carriers." They are not classed as railroads at all. They are allowed to enter into even this limited carrier business merely as an accommodation to the surrounding farmers, and they undertook such business for such purpose at a loss and as a patriotic duty during the war (Atlantic Coast Line Record, pp. 35 to 37).

It would call for much subtlety and an extreme technical refinement to apply the name of "railroads" to these lumber companies. But to ask this court to hold unconstitutional a State tax statute because it puts into one class all railroads and excepts these lumber roads from that class is a proposition which we do not think will bear examination.

As a last effort, however, to find some loophole in the classification created by the statute and laws of North Carolina and to show that there was at least one "public-service corporation" to be found which was not taxed like the appellants under section 202, the plaintiffs below introduced the affidavit of J. H. Bridgers (A. C. L. Record, pp. 33 to 47) who swore that he was president of the Henderson Water Company, and that his corporation was not required to keep its accounts according to the standard classification of the Interstate Commerce Commission and was not taxed under the provisions of section 202.

The result was that the tax clerk of the State department of revenue swore that Mr. Bridgers' company's return, to-

gether with returns of other corporations, had not yet been checked for correctness, but that if it was made as stated in Mr. Bridgers' affidavit it would have to be made again, and that his water company would most certainly be taxed under the provisions of section 202 of the act and would be allowed only those deductions in calculating taxable net income allowed to the plaintiff railroads (A. C. L. Record, p. 56).

3. *The Classification Made by the Statute is Perfectly Reasonable and Valid.*

The question always is, when a classification is made, whether there is any reasonable grounds for it, or whether it is purely and simply arbitrary, based upon no real distinction, and entirely unnatural. If the classification be proper and legal within this rule, then there is the requisite uniformity.

Gulf, etc., R. Co., v. Ellis, 165 U. S., 150;
Magoun v. Illinois Trust & Savings Bank, 170 U. S., 283;
Nichol v. Ames, 173 U. S., 509.

It is not only competent to make a separate class of all railroads, but it is competent for the Legislature to make classification within the general class of railroads. Thus it may make a separate class for taxation of only those railroad corporations using city streets.

Savannah, etc., R. Co. v. Savannah, 198 U. S., 392.

And it may make separate classes, distinguishing between surface railroads and sub-surface railroads.

New York v. N. Y. Tax Commissioners, 199 U. S., 53.

The equal-protection clause of the Fourteenth Amendment was not intended to prevent a State from adjusting its system of taxation in all proper and reasonable ways. It may, if it chooses, exempt certain classes of property from any taxation at all, such as churches, libraries, and the property of charitable institutions. It may impose different specific taxes upon different trades and professions and may vary the rates of excise upon various products; it may tax real estate and personal property in a different manner; it may tax visible property only and not tax securities for the payment of money; *it may allow deductions for indebtedness or not allow them.* All such regulations, and those of like character, so long as they proceed within reasonable limits and general usage, are within the discretion of the State Legislature, or the people of the State in framing their constitution.

> *Bell's Gap R. Co. v. Pennsylvania,* 134 U. S., 232, 237;
>
> *Pacific Express Co. v. Seibert,* 142 U. S., 339;
>
> *Adams Express Co. v. Ohio,* 165 U. S., 194.

Railroad companies are not discriminated against contrary to the equal protection clause of the Fourteenth Amendment by imposition upon them of an excise tax when other public utilities are not so taxed.

> *Ohio Tax Cases,* 232 U. S., 576.
>
> See also generally *Bickett v. Tax Commission,* 177 N. C., 433, and cases there cited.

A discrimination between corporations and individuals with regard to taxation cannot be pronounced arbitrary, al-

though the court may not know the precise ground of policy that led the State to insert the distinction in the law. The State may have a policy in taxation, and the courts may not review that policy.

Quong Wing v. Kirkendall, 223 U. S., 59, 63;
Ft. Smith Lumber Co. v. Arkansas, 251 U. S., 532.

We see at once that no contention of such discrimination in the Income Tax Act of 1921 as would violate either the State uniformity rule or the equal-protection clause of the Fourteenth Amendment can be maintained, because, as we have shown, all railroads are classed together and taxed exactly alike upon their incomes by North Carolina. All are taxed under the provisions of section 202. All make return for income tax on the same blank, form 7, Exhibit A to this brief. The taxable net income of all is ascertained from the items prescribed by the standard classification of accounts of the Interstate Commerce Commission.

It is beyond dispute that it is perfectly valid for the State to tax railroads alike in one class, and other corporations and individuals differently in other classes.

But the classification is even broader and more general than this. As we have seen, it not only includes railroads, but it includes all other public-service corporations. They all make return for income tax on the substantially similar form 8, Appendix B, according to the standard classification of accounts of the Interstate Commerce Commission, and they are also taxed under the provisions of section 202.

Here is classification of such broad and inclusive scope as creates a much greater uniformity and gives a far more equal protection of the laws even than is required by the State and Federal Constitutions. This classification is unassailable.

A glance at the cases cited by the plaintiffs as sustaining their contention that this tax violates the Fourteenth Amendment is sufficient to show the clear distinction between each of those cases and ours. They are:

Royster Guano Co. v. Virginia, 253 U. S., 412;
Gulf, etc., R. Co. v. Ellis, 165 U. S., 150;
Cotting v. Kansas City Stock Yards, 183 U. S., 79;
Connolly v. Union Sewer Pipe Co., 184 U. S., 540.

In the *Royster Guano Co. case, supra,* there was no question of differences in method of ascertaining the net income of various classes of taxpayers, as in our case, but the question was the direct one, whether it was competent for the State to tax a certain class of income of certain domestic corporations and leave untaxed the same class of income as to other domestic corporations. Our case shows slight differences between classes in method of ascertainment of a tax on net income which is imposed at the same rate on taxpayers of all classes. That case showed a tax imposed on income of a fixed class as to certain corporations, and no tax at all imposed in the very same class of income as to other corporations. That case shows by contrast what is a really arbitrary classification, made on no reasonable or practicable basis, and that no such case is presented here.

The case of *Gulf, etc., R. Co. v. Ellis, supra,* again shows an instance of a really arbitrary discrimination. In that case a State statute was attacked which penalized railroads for not paying certain money claims within a certain time after written notice of claim, by authorizing the recovery by the claimant of attorneys' fees in addition to the claim. No such recovery was allowed by any law of the State against

any person or corporation except railroads. The act singled railroads out and punished them for a delinquency for which no one else was punished. The Supreme Court held that there was no reasonable basis for the discrimination; that it was hostile and invalid. Even in that case three judges filed a vigorous dissent.

In the case of *Cotting v. Kansas City Stock Yards, supra,* the court passed upon the validity of a statute of Kansas which provided regulations for stock yards of a certain class, with penalties for violation, but which applied only to stock yards in one city of the State. It was held that the statute denied the equal protection of the laws to the stock yards of that one city; that the classification was arbitrary and unreasonable, because the regulations were not applied to all members of the class within the scope of the power of the State. So, if North Carolina imposed an income tax on such railroads as run through the city of Charlotte, leaving other railroads untaxed as to income, such imposition would undoubtedly be invalid. But the Income Tax Act does just what the statute condemned in the *Cotting case* did not do—that is, it applies to every member of the class within the jurisdiction of the State.

In *Connolly v. Union Sewer Pipe Co., supra,* the court declared to be a violation of the Fourteenth Amendment a State anti-trust act condemning a certain class of combinations and making illegal and void the contracts of such a combination, but expressly exempting from its operation exactly that same class of combination when made by farmers or livestock raisers. That statute was invalid for the same reason as the one condemned in the *Cotting case*—it did not apply to all members of the class affected (certain forms of

combination) within the scope of power of the State. That case is also clearly distinguishable from the case now presented to this court, for here all members of the class within the power of the State are affected and affected exactly alike.

The *Connolly case* is also interesting for the distinction it draws between the general regulatory powers of a State and the broader tax powers under the Fourteenth Amendment, which distinction has been referred to above.

The North Carolina cases cited by the plaintiffs as sustaining their allegation of unconstitutionality under the State uniformity clause, *State v. Williams,* 158 N. C., 610, and *Worth v. Railroad,* 89 N. C., 291, are so patently different from our case that they do not merit extended attention.

In *State v. Williams, supra,* the town ordinance was a clear, direct, hostile discrimination against non-resident merchants in favor of residents of the town. Of course, such discrimination was incompetent, just as it would be incompetent for North Carolina to impose an income tax on all railroad corporations incorporated in other States, leaving domestic railroad corporations free from income tax. No such thing has been done. All railroads, all public-service corporations, are taxed upon their income alike.

The case of *Worth v. Railroad, supra,* was a plain case of dividing railroad corporations into three classes, and making arbitrary and unreasonable differences in the taxes imposed upon each of the three sub-classes of railroads. Of course, the decision of that case has no pertinency to this discussion.

The appellants contend that it is unconstitutional discrimination against them that they are not allowed deduction from gross earnings of interest on bonded debt, and of rentals paid on long-term leases which amount to purchases

of other roads. We have already shown, under point I, that this is no discrimination at all, in view of the numerous deductions allowed the appellants by virtue of the standard classification of accounts, which deductions are not allowed to individuals and corporations other than public-service corporations, and in view of the fact that individuals are allowed no deduction of living or family expenses, without which expenses the individual or family could not continue to exist.

Section 307 of the act must be considered in connection with the deductions allowed in section 306 and those allowed appellants. That section is as follows:

> "SEC. 307. Items not deductible. In computing net income, no deduction shall in any case be allowed in respect of:
>
> "(*a*) Personal, living, or family expenses.
>
> "(*b*) Any amount paid out for new buildings or for permanent improvements or betterments, made to increase the value of any property or estate.
>
> (*c*) Any amount expended in restoring property for which an allowance is or has been made.
>
> "(*d*) Premiums paid on any life insurance policy."

Special attention is invited to subsection (*b*), which will be taken up again a little later in this brief. The statute which permits the Interstate Commerce Commission to provide the forms of accounting for interstate roads is section 8592, subsection (5) of the Compiled Statutes, 1918. This statute was held constitutional in *Interstate Commerce Commission v. Goodrich Transit Co.,* 224 U. S., 194. In the

special instructions of the Commission, effective July 1, 1914, it is declared:

> "The accounts prescribed for operating expenses are designed to show expenses of furnishing transportation service, including expenses of maintaining the plant used in the service."

This is, indeed, the key to the whole system of stating operating expenses. All the expenses of operating the railroad and all the expenses of maintaining them up to a definite standard are included in this standard classification of accounts required by the Interstate Commerce Commission. *Kansas City Railway Company v. United States,* 231 U. S., 423.

It is clear that the appellants by the very method of accounting required by the statute, get the full benefit of all the deductions allowed by section 306, except those stated in subsections 2 and 3. In addition to those deductions, they are also entitled to deductions for all expenses of maintenance of way and structures, maintenance of equipment, of traffic, and of transportation and general expenses. Included in these are repairs of all kinds, insurance of all kinds, legal expenses of all kinds, including the payment of damages recovered in actions at law against the railroads, replacements and depreciations of all kinds, many of which are made to increase the value of the property itself. From the nature of the property, it must be kept up to a certain standard, and all these expenses are allowed as deductions, and they are many more than allowed ordinary corporations under section 306, and some of them such items as cannot be deducted by such corporations under section 307.

In the case of other corporations, capital stock is in effect a liability. In applying the Income Tax Act to them, it would be folly to permit them to deduct dividends paid by them to their stockholders. Railroads now are almost wholly financed by bond issues. The interest on those bonds must be paid from their net earnings, just as dividends to the stockholders of ordinary corporations are paid from their net earnings. To refuse to permit railroads, therefore, to deduct payments of interest on their bonded indebtedness in ascertaining income for which they are taxable is not a discrimination forbidden by either the State or Federal Constitution.

That the Interstate Commerce Commission requires income accounts to be kept and reported to it by railroads engaged in interstate commerce, other than the accounts upon which the North Carolina statute bases the net income of these railroads for taxation in the State cannot, we submit, affect the constitution validity of the North Carolina statutes. We think we have shown in the first part of this brief that the Legislature may declare what is the net income of these railroads under the North Carolina Constitution, section 3 of article V. Legislation of this class can deal only with broad, general outlines, from the nature of the subject with which it is dealing. To arrive at the net earnings, net income, ot these enormous business enterprises which have ramifications in many directions and whose operations cover a number of States, is necessarily a long and intricate process. The General Assembly when it came to deal with the problem adopted as the basis of its computation these accounts, since 1906 required by the Interstate Commerce Commission to be kept by railroads of the class to which appellants belong.

In addition to the deductions allowed in the adoption of this method, the Legislature allowed also the deduction of uncollectible revenue, taxes paid in this State for the income year and car hire rentals. These last items are included in the income accounts as provided by the Interstate Commerce Commission.

The General Assembly, no doubt, regarded the rentals paid for leased roads as having no analogy to those rentals described in subsection 2, section 306, of the Income Tax Act allowed to individuals and ordinary commercial corporations. As to the appellants, the rentals paid by them for leased roads are not "rentals or other payments required to be made as a condition of the continued use or possession," of the property leased to them. These railroad leases are for very long terms and are accompanied by numerous collateral obligations, which in practical effect make the lessee the owner of the property for the period during which the lease is to run. Naturally, under any system of accounting the rentals paid under such contract are not part of the operating expenses.

But even if there were some discrimination in this respect, it would not be an invalid or unconstitutional discrimination, since it would apply to all members of the class of railroads and other public-service corporations. It is not every difference which constitutes a discrimination, and it is not every discrimination which creates a lack of uniformity under the State Constitution or a denial of equal protection of the laws under the Fourteenth Amendment. There can be no unconstitutionality under those provisions so long as there is competent classification, and every member of the class within the scope of power of the State is treated like

every other member of the class. It is that situation which we have here. The income tax, as applied to the plaintiffs, is neither a violation of the uniformity rule of the State Constitution nor of the Fourteenth Amendment.

If there is no unconstitutional discrimination against the appellants, but a reasonable classification in the Income Tax Act of 1921, then it follows that the income tax levied upon them by reason of their net earnings in the State, even if they include net gains from interstate commerce in the State, is not obnoxious to the commerce clause of the Federal Constitution (*U. S. Glue Co. v. Oak Creek, supra; Shaffer v. Carter, supra*) nor to the equal-protection and due-process clauses of the Fourteenth Amendment.

If it is within the constitutional power of a State to differentiate in classification in a tax statute between coal companies producing bituminous coal and those producing anthracite coal, under the circumstances under which that classification was held to be valid in the case of *Heisler v. Thomas Colliery Company*, decided November 27, 1922, we do not see how even a specious or plausible argument can be directed against the classification in the Income Tax Act of 1921 of North Carolina.

We think the opinions in that case and in the case of *Dane v. Jackson*, 256 U. S., 589, and of *Southern Railway Company v. Watts*, this term, contain the answer to every possible contention of the appellants in these suits.

III.

There is no merit in the contention that it is a violation of the State Constitution for the general-property tax to be devoted to local purposes and the various excise, privilege, franchise, and license taxes and the income taxes to be devoted strictly to State purposes.

This same contention was made by these appellants in the cases decided January 2d by this court, and was decided adversely to them.

IV.

This income tax being perfectly valid in itself, the fact of its being imposed in addition to property and franchise taxes cannot affect its validity.

This was decided in *Southern Railway Company v. Watts*, decided January 2, 1923, wherein the court said:

> "And there is no basis for the contention that the aggregate burden imposed by the property tax, the franchise tax, and the income tax, operates to obstruct interstate commerce."

V.

The validity of this tax cannot be affected by the fact that it exempts from its operation railroad corporations and other public-service corporations which derive their income not from operation of their property but from other sources.

By their contention that this tax is discriminatory against them because the method of ascertaining net income pre-

scribed by section 202 does not apply to railroad corporations which derive their income from sources other than the operation of their property, the plaintiffs have reference to the case of a railroad corporation which does no railroad business whatever, but which has leased its entire properties for a long term, say ninety-nine years, practically sold its properties, to a corporation which is conducting railroad operations, the lessor having no income whatever except from the rentals paid it by the lessee railroad.

To consider such a point as bearing on the constitutionality of the income tax would verily be to stick in the bark and not to consider the meaning of words, but their form.

When we say that all railroads are taxed alike under this act, we mean by the word "railroads" all corporations engaged in carrying on the business of railroading. We do not mean a corporation which has the word "railroad" as a part of its name, but which does no railroad business, merely leasing for a long term its entire properties to a corporation which is engaged in railroading.

Of course, such a lessor corporation is not taxed under section 202, because it keeps no standard classification of accounts, having only one item of revenue, to wit, the rentals paid it under the lease. It is not a railroad at all. Besides, it must not be forgotten that it is taxed on this income which it receives from rentals, just as any individual is taxed under the income tax under the general provisions of the act.

If the State were compelled to tax such a lessor corporation according to the standard classification of accounts, it would be impossible to tax it at all. It is not only a practical distinction to tax such a corporation under the general pro-

visions of the act, and to tax real railroad corporations under section 202, but it is a distinction which is absolutely necessary.

Another contention, made particularly by the Norfolk and Southern, is that it really pays two income taxes—one on its own income under section 202 and another on the income which it pays to its lessor corporation for the rent of their properties. This is not a situation produced by the laws of North Carolina, but by the voluntary contracts of the plaintiff.

North Carolina enforces against the Norfolk and Southern, as against any other of the plaintiffs, only the tax on its own income as ascertained under section 202. If the Norfolk and Southern is obliged to pay the tax on the income of its lessor, the Atlantic and North Carolina Railroad Company, it is not because any law of North Carolina imposes this obligation, but because the Norfolk and Southern voluntarily assumed this obligation by contract when it leased the properties of the Atlantic and North Carolina and agreed as part of the consideration of the lease to pay all taxes of the lessor.

If the Norfolk and Southern failed to pay lawful taxes of the Atlantic and North Carolina on the latter's income, the lien of the taxes would not be on the property of the Norfolk and Southern, but on that of the Atlantic and North Carolina. And the Norfolk and Southern is forced to pay such taxes, not to avoid a lien on its own property, but to avoid a forfeiture of its lease of the properties of the lessor.

The same situation is true as to all the plaintiffs which lease other smaller railroad lines. They are in the position of attacking the obligation of their own contract.

VI.

There is no merit in the contention that this income-tax statute is in violation of the Interstate Commerce Act, as seeking to prescribe a method of accounting for interstate carriers in conflict with powers delegated to the Interstate Commerce Commission.

The Income Tax Act of 1921 does not prescribe, nor does it seek to prescribe, any method of accounting for interstate carriers in violation of powers delegated to the Interstate Commerce Commission. It very specifically and clearly directs that returns for income tax shall be made strictly according to the accounting system which the said interstate carriers are now using, the standard classification of accounts of the Interstate Commerce Commission, and which they are using under authority of Congress. There is no merit in this contention of the plaintiffs; there is no basis for it in fact.

VII.

This statute is not invalid as being retroactive.

Two of the appellants, Seaboard Air Line and Atlantic Coast Line, contend that the act is invalid in so far as it is retroactive as to income received in January, February, and in the first eight days of March, the act having been ratified and become effective on March 8, 1921, and taxing the income of the taxpayer for the calendar year 1921.

The courts hold uniformly, however, that such an act is

not retroactive within the constitutional inhibitions and is valid.

State v. Bell, 61 N. C., 76;
Stockdale v. Insurance Co., 20 Wall., 323;
Flint v. Stone Tracy Co., 220 U. S., 108;
Brushaber v. Union Pacific R. Co., 240 U. S., at 20.

VIII.

The injunctions prayed were properly refused because, even if the income tax were invalid and were not enjoined, there would be no irreparable injury to the plaintiffs, since they have an adequate remedy at law to recover payments illegally exacted.

The statute here brought in question, in section 701, expressly provides an appeal from the State Tax Commission (now Commissioner of Revenue, Public Laws 1921, ch. 40) to the Superior Court, as follows:

> "Sec. 701. *Appeal.*—Any taxpayer may file formal exceptions to any finding by the State Tax Commission with respect to his taxable income, and upon such exceptions being overruled, any such taxpayer shall have the right, upon the payment of the amount of tax found by the State Tax Commission to be due, and upon filing bond for costs in the sum of two hundred dollars, to have the record in such case certified to the Superior Court of the county in which the taxpayer resides, or has his principal place of business, within thirty days after notice by the the Tax Commission of its determination, given as provided in section 700 of this act. Thereupon, appropriate proceedings shall be had and the relief, if any, to

which the taxpayer may be found entitled may be granted and any taxes, interest or penalties paid, found by the court to be in excess of those legally assessed, shall be ordered refunded to the taxpayer, with interest from time of payment."

In addition to this, the General Assembly, at its extra session in 1921, chapter 96, enacted the following law:

"Section 1. Whenever taxes of any kind are or have been through clerical error, or misinterpretation of the law, or otherwise, collected and paid into the State Treasury in excess of the amount legally due the State, the State auditor shall issue his warrant for the amount so illegally collected, to the person entitled thereto, upon certificate of the head of the department through which said taxes were collected or his successor in the performance of the functions of that department, with the approval of the Attorney General, and the Treasurer shall pay the same out of any funds in the treasury not otherwise appropriated: *Provided,* demand is made for the correction of such error or errors within two years from the time of such payment: *Provided further,* that claims which have arisen within the five years next preceding the ratification of this act shall be presented and made within two years from the ratification of this act."

The court below properly refused the injunctions prayed, because there was no threatened irreparable injury alleged or shown, in view of the statutes above quoted.

Indiana Mfg. Co. v. Koehne, 188 U. S., 681.

In that case it was said:

> "The absence of an adequate remedy at law is not shown by an averment in the bill which seeks to enjoin the collection of a tax on property alleged to be exempt from taxation, that a portion of the tax is to be paid to the State of Indiana, which cannot be sued, where under the general tax laws of that State complainant might have had its objections to the assessment reviewed by State board and then have filed a petition with the board of county commissioners to recover it back as wrongfully assessed, and if still unsuccessful, might have appealed from the decision of such board to the courts. Irreparable injury cannot be inferred as the result of the enforcement of an illegal tax, so as to sustain a suit in equity to enjoin its collection, where there is a plain and adequate remedy at law to recover the amount of the tax wrongfully assessed. A Federal court is not vested with jurisdiction of a suit in equity to enjoin the collection of a State tax because the case is one arising under the Constitution and laws of the United States within the meaning of the judiciary act of August 13, 1888, unless there is apparent some ground of equitable jurisdiction recognized by the Federal courts."

This was approved by memorandum opinion in *Foster v. Rowe,* 207 U. S., 581, and in *Dalton Adding Machine Co. v. State Corporation Commission,* 236 U. S., 699.

In addition to the statutes cited and quoted hereinbefore in this brief, section 7979 of the Consolidated Statutes of 1919 provides this remedy for taxpayers, and requires the State Treasurer expressly to refund the money so illegally collected if judgment is obtained for that amount. Section

7979 is a permanent part of chapter 131 of the Consolidated Statutes of 1919, entitled "Taxation," and it is located in article 10 of that section, entitled "General Provisions." It is expressly declared in section 7974, subsection 4: " 'Sheriff.' Every person who is by law authorized to collect taxes, either State or municipal." Section 7979 is as follows:

> "*Remedy of Taxpayer for Unauthorized Tax.*—Unless a tax or assessment, or some part thereof, be illegal or invalid, or be levied, or assessed for an illegal or unauthorized purpose, no injunction shall be granted by any court or judge to restrain the collection thereof in whole or in part, nor to restrain the sale of any property for the nonpayment thereof; nor shall any court issue any order in claim and delivery proceedings or otherwise for the taking of any personalty levied on by the sheriff to enforce payment of such tax or assessment against the owner thereof. Whenever any person shall claim to have a valid defense to the enforcement of a tax or asesssment charged or assessed upon his property or poll, such person shall pay such tax or assessment to the sheriff; but if, at the time of such payment, he shall notify the sheriff in writing that he pays the same under protest, such payment shall be without prejudice to any defenses or rights he may have in the premises, and he may, at any time within thirty days after such payment, demand the same in writing from the treasurer of the State or of the county, city, or town, for the benefit or under the authority or by request of which the same was levied; and if the same shall not be refunded within ninety days thereafter, may sue such county, city, or town for the amount so demanded, including in his action against the county both State and county tax; and if upon the trial it

> shall be determined that such tax or any part thereof was levied or assessed for an illegal or unauthorized purpose, or was for any reason invalid or excessive, judgment shall be rendered therefor, with interest, and the same shall be collected as in other cases. The amount of State taxes for which judgment shall be rendered in such action shall be refunded by the State treasurer."

It is true that this statute permits an injunction in the State courts against the collection of an illegal or invalid tax (*Railroad Co. v. Commissioners*, 148 N. C., 220). In this particular it is not to be followed by the Federal courts. The authority of those courts is limited by section 267 of the Judicial Code (R. S., sec. 723, 36 Stat., 1163), which is as follows:

> "Suits in equity shall not be sustained in any court of the United States in any case where a plain, adequate and complete remedy may be had at law."

This is the limit of authority of courts of the United States and it cannot be extended by State legislation.

Whitehead v. Shattuck, 138 U. S., 146.

In these cases the injury apprehended by the plaintiffs is that they will be compelled to pay their income taxes to the State Treasurer: the Southern, $71,522.06; the Seaboard, $13,133.09; the Atlantic Coast Line, $41,686.96, and the Norfolk and Southern, $19,616.46.

It is paying out of these respective amounts of money which the plaintiffs allege to be an irreparable injury. This can be so only if they cannot bring suit to recover these amounts back from responsible defendants.

The fullest kind of remedy at law is provided whereby the plaintiffs can, like all other taxpayers, recover back all illegally levied or paid taxes. The injury apprehended cannot, therefore, be irreparable, and the injunctions applied for, we respectfully submit, should be refused.

Keokuk & H. Bridge Co., v. Salm, 258 U. S., 122.

We respectfully submit, however, that we have shown upon the merits that none of the contentions of the appellants can be sustained, and that the statute here attacked is valid and constitutional, and that the decree of the District Court should be in all respects affirmed.

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THOS. D. WARREN,
SIDNEY S. ALDERMAN,
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APPENDIX A.

Form 7.

STATE DEPARTMENT OF REVENUE.

Public-service Corporation Income Tax Return (*Railroads*) *for Calendar Year Ending December* 31, 1921.

Name ....

Business address ....

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the regulations issued under authority thereof.

....

President.

....

Treasurer.

Sworn to and subscribed before me, this ...... day of ......, 1922.

....

....

(Official capacity)

*Net operating income (when business is wholly within the State)..........	$......	
*Net operating revenue, including equal mileage proportion within this State of the interstate business (when business is in part within and in part without the State)..................	$......	
Other income.....................	$......	
Total income......................		$......
*Operating expenses (when business is wholly within the State)..........	$......	
*Proportionate average of operating expenses (when business is in part within and in part without the State)	$......	
*Uncollectible revenue...............	$......	
Taxes paid in this State, other than income and war profits and excess profits taxes.....................	$......	
Total deductions....................		$......
Operating income, less deductions.......		$......
Plus or minus any credit or debit balance received or paid on account of car hire. And when any railroad is partly within and partly without the State then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid............		$......
Net taxable income..................		$......
Tax at 3 per cent......................		$......
Main track mileage (system)	......	
Main track mileage (State)..	......	

*As per standard Classification of Accounts of Interstate Commerce Commission.

APPENDIX B.

Form 8.

STATE DEPARTMENT OF REVENUE.

Public-service Corporation Income Tax Return, Other Than Railroads, for Calendar Year Ending December 31, 1921.

Name and kind of business........................

Business address...................................

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the regulations issued under authority thereof.

....

President.

....

Treasurer.

Sworn to and subscribed before me, this ...... day of ......, 1922.

....

....

(Official capacity)

Operating Revenues, in this State, including mileage proportion of interstate business as per standard Classification of Accounts of Interstate Commerce Commission..........................	$......
Operating Expenses, as per standard Classification of Accounts of Interstate Commerce Commission	$......
Net operating revenue..................	$......
All other income..........................	$......
Total income..........................	$......
Less taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes..........................	$......
Net taxable income....................	$......
Tax at 3 per cent..........................	$......